

**The Internal Revenue Service Continues to
Owe Millions of Dollars in Interest to
Taxpayers with Frozen Refunds**

March 2002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 12, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Continues to
Owe Millions of Dollars in Interest to Taxpayers with Frozen
Refunds (Audit # 200130023)

This report presents the results of our follow-up review that assessed whether the recommendations made in our earlier report titled, *Controls Should Be Strengthened Over Business Taxpayer Accounts with Frozen Million Dollar Refunds*,¹ were implemented and effective. In summary, the Office of Audit first reported in September 1999 that the Internal Revenue Service (IRS) was experiencing problems in releasing large dollar refunds because of the automatic freeze placed on accounts containing a credit balance of \$1 million or more. Among the findings we reported were that controls did not ensure that frozen refunds were timely released and additional interest of approximately \$17.5 million was paid to taxpayers with frozen accounts.

In this follow-up review, we found that the IRS did not implement our recommendations as agreed, and it continues to pay millions of dollars in interest to taxpayers with frozen refunds. We reviewed 412 frozen accounts and found that 209 (51 percent) improperly frozen accounts resulted in issuing approximately \$185.8 million in refunds and paying taxpayers an additional \$15.4 million in interest. The IRS needs to take actions that will provide the government an opportunity, over a 5-year period, to potentially put an estimated \$12.9 million that it paid in interest to better use.

¹ Reference Number 199940057, dated September 1999.

Management's Response: Management's response was due on March 1, 2002. As of March 7, 2002, management had not responded to the draft report.

Copies of this report are also being sent to IRS officials who are affected by the recommendation. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs) at (202) 622-3837.

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Background

The Internal Revenue Service (IRS) issues billions of dollars in refunds each year through its automated and manual systems. In Fiscal Year (FY) 2000 alone, the IRS issued \$196 billion in refunds.

However, if a large dollar refund is due, the IRS' computers are programmed to freeze the taxpayer's account from refunding automatically. The freeze condition places a *Million Dollar Freeze* indicator on the account, which alerts IRS employees to release the refund manually. The manual refund procedure is designed to avoid paying interest to the taxpayer by ensuring large dollar refunds are issued promptly.

Prior to January 2001, the IRS considered large dollar refunds to involve \$1 million or more. However, the threshold for establishing the *Million Dollar Freeze* was subsequently increased to refunds involving \$10 million or more.

We performed this review as part of our responsibility under the *Government Auditing Standards* to determine the effectiveness of actions taken on reported audit findings. Our review was conducted in the Ogden Submission Processing Center from June to October 2001 and performed in accordance with the *Government Auditing Standards*. In performing the review, we relied on computer-processed data extracted from IRS' computer systems. Based on our tests, we concluded the data was sufficiently reliable to meet our objective. Detailed information on our objective, scope and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Corrective Actions Taken Did Not Effectively Address Accounts with Frozen Large Dollar Refunds

The General Accounting Office's *Standards for Internal Control in the Federal Government* recommends that managers take prompt action to correct problems identified by auditors. Specifically, federal managers are to: (1) evaluate findings and recommendations reported by auditors, (2) determine the actions to take in response to the findings and recommendations, and (3) complete actions that correct the problems brought to their attention.

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In 1999, we reported¹ that the IRS was experiencing problems in releasing large dollar refunds because of the automatic freeze placed on accounts containing a credit balance of \$1 million or more. Among the problems we reported were that: (1) computer and other controls did not ensure frozen refunds were timely released, and (2) additional interest of approximately \$17.5 million was paid to 44 taxpayers with frozen accounts.

To correct these problems, we recommended that the IRS change its computer system to systemically release refunds that fall below the *Million Dollar Freeze* threshold and establish alerts for employees to take appropriate resolution actions on frozen accounts. Instead of implementing our recommendations as agreed, the IRS increased the threshold for automatically freezing refunds from \$1 million to \$10 million. However, increasing the threshold did not correct the problem, and the IRS continues to owe millions of dollars in additional interest to taxpayers with frozen accounts.

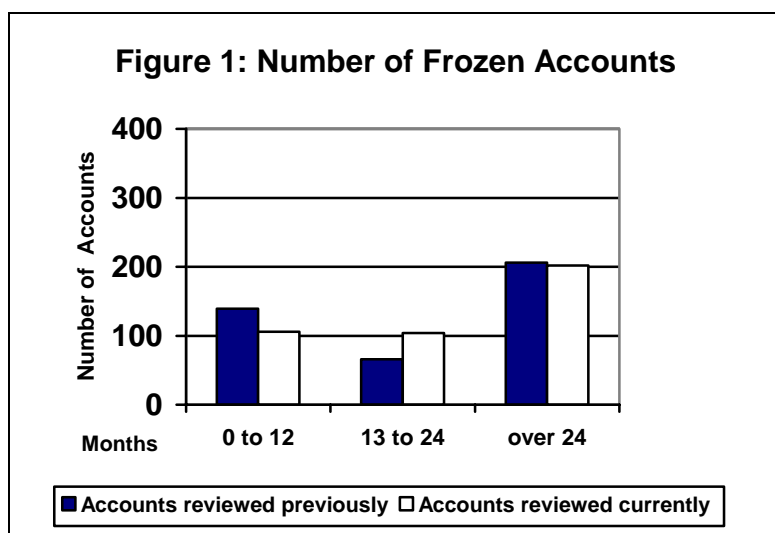
Our review of all 412 accounts with a *Million Dollar Freeze* indicator on the IRS' Masterfile² found 209 (51 percent) that were improperly frozen as of March 31, 2001. The 209 improperly frozen accounts resulted in the IRS issuing approximately \$185.8 million in refunds to taxpayers and paying them an additional \$15.4 million in interest. IRS officials are reviewing another 174 accounts to determine if they are also accruing additional interest because they are improperly frozen.

¹ *Controls Should Be Strengthened Over Business Taxpayer Accounts with Frozen Million Dollar Refunds* (Reference Number 199940057, dated September 1999).

² The Masterfile is the IRS' main computer system containing taxpayer accounts.

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Figure 1 shows a comparison between the accounts we found frozen in our previous review and the ones we found in this review.



Source: Extracts from IRS' Masterfile on April 4, 1998, and March 31, 2001.

There are two reasons why the IRS' corrective action was not effective. First, refunds can drop below the *Million Dollar Freeze* threshold, which is now set at \$10 million. For example, when transactions reduce a \$10 million dollar credit balance in an account to \$8 million, the IRS computer system does not automatically refund the \$8 million credit to the taxpayer. Instead, it remains frozen until an IRS employee takes steps to remove the freeze and manually release the refund. Second, IRS employees are not always aware of the need to take appropriate resolution actions on accounts frozen for extended periods. As we reported previously, the *Million Dollar Freeze* indicator is not displayed on key computer screens used by employees to resolve problem accounts. In addition, the system does not generate periodic alert notices to employees on frozen accounts.

Consequently, we continue to believe that systemically releasing refunds that fall below the *Million Dollar Freeze* threshold and establishing alert mechanisms for employees are needed to correct the problem with frozen refunds.

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Taking these actions will provide the government an opportunity over a 5-year period to potentially put an estimated \$12.9 million (an average of \$2.5 million a year) that it paid in interest to better use. The money that may be available over the 5-year period is the additional interest calculated by IRS officials in the Ogden Submission Processing Center and paid to taxpayers during our review.

Recommendations

The Director, Customer Account Services, Small Business/Self-Employed (SB/SE) Division, needs to initiate actions that will:

1. Modify the IRS' computer system to systemically release the newly established *Million Dollar Freeze* for credit balances that fall below the \$10 million threshold.
2. Establish indicators on key computer screens and generate periodic notices as alerts for employees to review accounts with *Million Dollar Freeze* and take appropriate resolution actions.

Management's Response: Management's response was due on March 1, 2002. As of March 7, 2002, management had not responded to the draft report.

Control Weaknesses Expose the Government to Potentially Significant Losses

The IRS successfully authorizes millions of refunds each year through its manual and automated systems. The manual process can be used when it is important to ensure the refund is made promptly. This helps minimize or avoid interest paid to the taxpayers, which is important when a taxpayer is due a large refund.

However, there is a control weakness between the IRS' automated and manual refund processes that can increase the risk of issuing duplicate refunds. To correct this weakness, the IRS established guidelines for its staff to follow before initiating a manual refund. Specifically, the guidelines recommend that employees review the Masterfile to determine if another refund has already been issued and, if necessary, take steps to prevent a duplicate refund from being generated.

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We selected for review the accounts of business taxpayers that were issued one or more million dollar refunds between January 1, 2000, and March 31, 2001. Our review identified 3 duplicate refunds totaling \$8.2 million that were issued after the threshold for freezing accounts was increased to \$10 million. Although the taxpayers and the IRS detected the errors and the money was returned, the condition exposes the government to potentially significant losses due to inappropriate refunds.

The duplicate refunds were issued because employees did not properly monitor the Masterfile in preparing manual refunds. Discussions with several employees indicated that they had not received recent training in preparing manual refunds and were incorrectly initiating manual refunds that are now automatically released under the new *Million Dollar Freeze* threshold.

Recommendation

3. The Director, Customer Account Services, SB/SE Division, should coordinate efforts to provide updated training for employees that manually initiate refunds. The training could be accomplished in staff meetings by emphasizing the importance of monitoring the Masterfile during the manual refund process and only using the process when it is appropriate.

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Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine if the recommendations made in our report titled, *Controls Should Be Strengthened Over Business Taxpayer Accounts with Frozen Million Dollar Refunds*¹ were implemented and effective. We performed work at the Ogden Submission Processing Center. Our work was focused in the following areas:

- I. Determined if agreed upon recommendations from the initial review were implemented.
 - A. Reviewed Treasury's Inventory Tracking and Closure System to determine the implementation dates of planned corrective actions for the recommendations in the prior report.
 - B. Reviewed memoranda and other supporting documentation to determine if planned corrective actions for the recommendations in the prior report were completed.
 - C. Performed a walk through of the appropriate operations in the Ogden Submission Processing Center to determine what procedures were implemented and/or in place to expedite the resolution of frozen million dollar refunds.
- II. Quantified the outcome measure (funds put to better use) associated with the Internal Revenue Service's (IRS) corrective actions by determining the amount of additional interest expense incurred by the IRS because refunds were not released timely.
 - A. Reviewed all 412 accounts containing a *Million Dollar Freeze* indicator from a March 31, 2001, extract of the IRS' Masterfile² and determined that 209 accounts were improperly frozen and accruing interest.
 - B. Coordinated with IRS officials in the Ogden Submission Processing Center to assess the accuracy of our review results and determine the amount of refunds and additional interest due to taxpayers with improperly frozen accounts.
- III. Determined if the IRS' corrective actions created any duplicate refund conditions.
 - A. Analyzed an extract from the IRS' Masterfile of accounts of business taxpayers that contained one or more refunds issued of \$1 million or more during the 15-month period ending March 31, 2001.

¹ Reference Number 199940057, dated September 1999.

² The Masterfile is the IRS' main computer system containing taxpayer accounts.

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- B. Coordinated with IRS officials in the Ogden Submission Processing Center in assessing the cause for any duplicate refunds issued and how they were resolved.
- IV. Reconciled 11 data fields extracted from the IRS' Masterfile and assessed whether the extracted data was sufficiently reliable to meet our objective.

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Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Philip Shropshire, Director

Frank Dunleavy, Audit Manager

Jean Kao, Auditor

William Tran, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
Field Director, Accounts Management, Ogden Submission Processing Center,
Small Business/Self-Employed Division S:CAS:AM:O
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; An average of \$2.5 million per year; \$12.9 million over 5 years (see page 1).

Methodology Used to Measure the Reported Benefit:

To estimate the potential funds that could be put to better use because of our recommendations, we used the additional interest that was calculated by Internal Revenue Service (IRS) officials in the Ogden Submission Processing Center and subsequently paid into 104 taxpayer accounts that were improperly frozen 5 years or less. Although we found that 209 taxpayers had improperly frozen accounts and that the IRS paid a total of \$15.4 million in additional interest, we limited the reported benefit to the additional interest that was paid to the 104 taxpayers who had their accounts frozen 5 years or less.

The additional interest that accrued each year on the accounts that were improperly frozen was not available. Consequently, the average of \$2.5 million per year that potentially could be put to better use is presented for informational purposes. It is the quotient of dividing \$12.9 million by 5 years.